Postal Regulatory Commission
Submitted 2/12/2016 2:49:31 PM
Filing ID: 94988
Accepted 2/12/2016

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Annual Compliance Report, 2015	)))	Docket No. ACR2015

VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
REPLY COMMENTS ON THE UNITED STATES POSTAL SERVICE
FY 2015 ANNUAL COMPLIANCE REPORT
(February 12, 2016)

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Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. ("Valpak") submitted Initial Comments on February 2, 2016, and submit the following Reply Comments in response to the Initial Comments filed by certain other commenters.

REPLY COMMENTS

I. American Catalog Mailers Association

Regardless of whatever dismal financial facts the latest ACR may contain — be it the Postal Service's poor financial condition and deteriorating outlook generally, or the massive losses incurred in handling Standard Flats specifically — ACMA can be counted on to urge that the Commission ignore its responsibilities, look the other way, and allow the Postal Service to keep the subsidies flowing to ACMA members. This is illustrated by the following excerpts from ACMA's Initial Comments:

- "It would be best not to plan significant rate adjustments at this time." *Id.* at 4.
- "It should be given more time." *Id.*
- "It would be best not to pursue significant rate adjustments at this time." *Id.* at 5.
- "[N]o special steps should be taken to increase the levels of SF [Standard Flats] rates." *Id.* at 9.

ACMA's entire filing could be summarized as: "move on, nothing to see here; please disperse; nothing to see here, please."[1]

ACMA is aware that the unit cost and annual losses on Flats increased sharply in FY 2015. But ACMA argues that rates should not be increased to offset such losses because that might "drive flat volume out of the mailstream." *Id.* at 4. Of course, from past filings we

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[1] https://www.youtube.com/watch?v=pdFl__NlOpA

know that had unit cost declined, even a smidgen, rather than increased sharply as it did this past year, ACMA would have trumpeted that fact to support its consistent plea for no meaningful price increase for Standard Flats.

When it comes to predicting the future, ACMA regularly advises the Commission that things are improving for Standard Flats, if only the Commission will defer any price increase and allow the Postal Service to have a little more time. Here, despite that product's unit cost increases in both FY 2014 and 2015, ACMA prognosticates:

> Flats automation appears to be **on a path to lower costs** and improved efficiency. [*Id.* at 4 (emphasis added).]

ACMA proffers not one fact or shred of actual evidence on which the Commission reasonably could rely to support that speculation. After seven consecutive dockets in which ACMA has sung that particular song with no meaningful results,[2] it would be arbitrary and capricious for the Commission now to defer significant remedial action any further.

ACMA's rosy outlook differs strikingly not just from the detailed recitation contained in Valpak's Initial Comments (at 2-19), but also from the Initial Comments of MPA, whose Table 1 indicates that unit mail processing and delivery costs for FSS flats were more than double the corresponding costs for Carrier Route Basic flats in FY 2015. As MPA documents, the requirement that certain low-cost Carrier Route flats divert to high-cost FSS has contributed to sharply higher unit costs.

This year, ACMA adds an argument that is not just new, but fantastical. ACMA opines that one reason for not increasing Standard Flats rates is that the industry is "still

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[2] *See*, *e.g.*, Docket No. ACR2009, ACMA Reply Comments at 5.

reeling from the significant increases that resulted from Docket No. R2006-1." *Id.* at 4. The price increases referred to occurred on **May 14, 2007!** In other words, nearly **nine years after** the complained-of price increases, the catalog industry is "still reeling," having not adjusted to those higher rates. The Commission is on record rejecting the notion that a business cannot adjust far more rapidly than nine years. Consider how the Commission reacted to a similar recent argument when made by the Postal Service in seeking unlimited increased exigent prices for the foreseeable future. In the appeal of Docket No. R2013-11, the D.C. Circuit also rejected the Postal Service's argument that it needed two to four years to adjust to the "new normal." Alliance of Nonprofit Mailers, *et al.* v. Postal Regulatory Commission, 790 F.3d 186, 194-95 (D.C. Cir. 2015). The Commission should reject ACMA's similar argument made here.

Faced with the clear statement in this year's ACR (at 17) that the Postal Service agrees with the Commission that having products cover their costs is an appropriate goal, ACMA states that it fully:

> understands that **steps toward this "goal"** could involve **increasing SF rates** and lowering HD [High Density/Saturation Flats & Parcels] and CR rates. [*Id.* at 4 (emphasis added).]

However, ACMA urges the Commission not to order the Postal Service to take meaningful steps toward any such agreed goal, no matter how desirable everyone apparently believes it would be. In other words, ACMA opposes any action by the Commission to require adjusting prices in a way designed to (i) discourage use of products handled inefficiently and at high cost, and (ii) encourage use of products the Postal Service has demonstrated it can handle efficiently and at relatively lower cost.

One reason given by ACMA for no increase "at this time" is that "the system is in **the midst** of the largest flats automation project ever attempted." *Id.* at 4 (emphasis added). ACMA fails to mention that the FSS has been under development for many years, and by the end of 2011 the Postal Service had deployed all 100 of its new machines. The technology presumably is in use at least 5 days a week, 52 weeks a year. After 4 full years of operation (and now well into the fifth year), the FSS should be a mature endeavor — certainly not to be viewed as being "in the midst" of some new automation project. All that the Postal Service is doing now with FSS are tweaks and improvements for which it can provide no cost saving estimates. FY 2015 ACR at 19, 23, 25-27. There is no reason to forestall any longer a meaningful remedial price increase while waiting for FSS to demonstrate a significant breakthrough reduction in the end-to-end cost of processing and delivering Standard Flats.

This year, ACMA develops in some detail what may be its most interesting argument yet to forestall any meaningful rate increase and to continue incurring large annual losses on Flats in order to subsidize its members. According to ACMA:

> the rates for Commercial flats in the Standard class, with the possible exception of Saturation, have risen to a level that is at or above the standalone constraint, and that, **but for the mailbox rule** and the limited extent to which catalogs are constrained by the Private Express Statutes, **a private delivery service would happily provide service for these pieces** … but for the constraint of the mailbox rule, Publishers Express **would have continued expanding and would be delivering all, or nearly all, magazines** in the United States today, **along with many other machinable flats**. … It is unfair for catalog mailers to be **locked into rates that are higher than competition in a delivery market would offer.** [*Id.* at 6-8 (emphasis added).]

The mailbox rule is a critical part of the Postal Service's statutory monopoly. Under normal economic conditions, the role of a monopoly is to help **protect the incumbent Postal**

Service's profits. In this case, however, according to ACMA, the mailbox rule and the monopoly are helping to **protect the Postal Service's losses** on catalogs, *i.e.*, but for the mailbox rule, a private delivery market would arise and deprive the Postal Service of its hundreds of millions of dollars of annual losses on catalogs.[3] ACMA infers that one solution, perhaps its preferred solution, would be to relax the mailbox rule and let private delivery compete. ACMA's speculative argument bears little relation to reality, for the mailbox rule is not about to be relaxed. The annual losses and subsidy to catalogs can be expected to continue *ad infinitum* — unless the Commission acts as a regulator and orders that the losses cease, or at least be reduced substantially, *e.g.*, by at least 50 percent below the FY 2015 level.

Many of the arguments that ACMA has raised in the past are wholly unavailable in the current docket focusing on FY 2015, for which aggregate losses (even with the additional exigent surcharge revenue and the May 31, 2015 price increase) were **$522 million**, unit losses were **9.9 cents**, and coverage was only **80.2 percent**. One would have assumed that there would be little positive for ACMA to find in these dismal data, but ACMA has attempted nevertheless, by constructing a highly misleading presentation of postal finances in its Table 1.

> First, Table 1 has the heading "**FY 2015**." However, the numbers do not report on all of FY 2015 — only to the **last four months of FY 2015** (June 1 - September 30, 2015), after the May 31, 2015 price increase went into effect — a fact that is discerned from the accompanying text. Nevertheless, in its ACD, the Commission cannot

[3] ACMA's argument requires coining a new term concept for the economist's lexicon. The notion of "monopoly profits" is well established. Now ACMA's argument is based on a new notion of "monopoly losses" — recurring losses shielded from competition by a statutory monopoly.

evaluate compliance with law based on a partial year, as it is tasked by statute to review data for the entire fiscal year. 39 U.S.C. § 3653(b).

Second, Table 1 only reports on "**commercial**" cost coverages for selected products — despite the fact that the coverage for every Standard Mail product has always been evaluated by examination of each product's total volume — commercial and nonprofit. This is the system established by Congress, and the Commission cannot yield to ACMA's entreaty just to ignore it. 39 U.S.C. § 3626(a)(6).

Third, Table 1 does not show coverages for each product separately, as they must be evaluated (*see* 39 U.S.C. § 3652(a)(2)), but artificially combines Standard Flats with Carrier Route, so as to find some way in which to show the Commission a positive coverage.

When the ACMA's manipulation of data in this table is put aside, so that all of FY 2015 is examined, including both commercial and nonprofit mail, even ACMA's artificial combination of Standard Flats and Carrier Route would produce a combined coverage of only **100.2 percent**. *See* Valpak Initial Comments at 13, Table I-2. With cost increases since last year, doubtless even this artificial combined coverage percentage has now gone negative. Moreover, once the exigent price increase is removed in April 2016, and as costs increase (with no CPI price increase anticipated for CY 2016), the combined coverage of Flats and Carrier Route will drop even further into negative territory.

Lastly, ACMA asserts that some catalogs are entered as HD/Saturation Flats & Parcels, some as Carrier Route, some as Standard Flats, and some "other categories" which are unspecified. However, ACMA fails to report on how much catalog volume is entered in each category. ACMA heads the list of products used with the most profitable product "HD/Saturation Flats & Parcels," but from prior ACMA filings, it would appear that of all products used by catalogs, this is by far the least used.[4] Although ACMA touts the higher coverage of the saturation product, that operates primarily as a smokescreen to give the illusion of catalogs being a profitable type of mail for the Postal Service. In truth, Standard Flats lose so much money that, even when combined with Carrier Route mail, after the exigent price increase is removed in April 2016, the coverage of these two artificially combined products will fall from **100.2 percent** to **96.1 percent**. *See* Valpak Initial Comments at 13 (Table I-2).

The Commission must once again disregard the data manipulations presented by ACMA and act based on the reality that its remedial order for Standard Flats in the FY 2010 ACD has proven woefully inadequate and ineffective to remedy the violation of law the Commission found. A dramatic remedial price increase for Standard Flats now is the only course available — short of ordering the Postal Service to discontinue the product entirely, another option the Commission was given by Congress. *See* 39 U.S.C. § 3662(c).

II. MPA

MPA's Initial Comments conclude that postal pricing is in serious need of reform. Despite all the long-term emphasis on developing accurate cost information, MPA's comments demonstrate that pricing too often ignores costs and fails to set prices designed to promote efficiency and reduce costs. For example, MPA criticizes postal **pricing** changes made in May 2015:

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[4] *See* Docket No. ACR2012, ACMA Initial Comments at 2.

> The changes made to the Periodicals rate design in FY 2015 were steps backward. They *worsened* the economic disincentives against Carrier Route preparation and comailing, both of which could greatly reduce Postal Service costs. [*Id.* at 3 (italics original).]

In addition to counter-productive pricing, MPA points to equally counterproductive **regulations** that require publishers to convert low-cost Carrier Route basic flats to high-cost FSS preparation. *See id.*, Table 1, p. 5, which shows the cost of FSS Automation Flats is **more than double** the cost of Carrier Route Basic. Although MPA limits its discussion to Periodicals, the problem highlighted by MPA extends directly to Standard Flats,[5] where the Postal Service's refusal to reflect costs in the price of Standard Flats needlessly elevates prices of non-flat products, such as HD/Saturation Letters used by Valpak.

III. Pitney Bowes and National Postal Policy Council

The Initial Comments of Pitney Bowes ("PB") discuss the "continuing disparity in the unit contribution and cost coverage of First-Class Single-Piece and Presort Letters." *Id.* at 1. PB identified the disparity in cost coverages between the two major First-Class Mail products — 186.0 percent for Single-Piece and 318.9 percent for Presort (*id.*), a **difference of 132.9 percentage points**. Similarly, the National Postal Policy Council ("NPPC") compared the cost coverages of First-Class Mail Presort Letters (318.55 percent) and Cards (328.44 percent)

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[5] With respect to FSS prices causing migration of Carrier Route FSS pieces to Standard Flats, the Association of Postal Commerce's Initial Comments state that "Postal Service management appears unable to control costs, … appears to make decisions without regard to achieving the lowest combined … costs [and] prices are established in a vacuum, without feedback or analysis from the industry prior to implementation." PostCom Initial Comments at 8.

with the market-dominant systemwide average (183.41 percent), a difference of 135.14 points and 145.03 points, respectively. *See* NPPC Initial Comments at 6.

PB explains that, although the disparity improved ever so slightly in FY 2015, "[t]he continuing disparity … harms the Postal Service financially and discourages the growth and retention of the most profitable First-Class Mail products." PB Initial Comments at 2. NPPC states that excessively high coverages also result in "harming business mailers and giving them reason to migrate away from the postal system to the long-term financial detriment of the Postal Service." NPPC Initial Comments at 6. Similarly, Valpak discussed how the disparity of unit contribution and cost coverage among products in Standard Mail discourages the most profitable mail and encourages the least profitable. *See* Valpak Initial Comments at 15-19.

PB notes the financial harm to the Postal Service from the disparity in coverage. In Standard Mail, however, the disparity is even worse than what PB identified. The difference in cost coverage between Standard Flats and HD/Saturation Letters, at **138.3 percentage points**, is slightly wider than the products within First-Class Mail. And, at least PB's product with the lower coverage, Single-Piece First-Class Mail, is quite profitable. By way of contrast, Standard Flats cost coverage was only 80.2 percent, making it devastatingly unprofitable.

PB also identified as a matter of concern the 3.6 cent difference in unit contribution between the First-Class single-piece and presort products. Between Standard Flats and HD/Saturation Letters, however, the difference in unit contribution is an astonishing **18.2 cents**, caused in no small part by the fact that **the Postal Service loses 9.9 cents on every Standard Flat entered**. *See* Valpak Initial Comments at 19.

PB's solution to the problem of disparity within First-Class Mail is for the "Postal Service to use its pricing flexibility to rebalance the cost coverage and unit contributions among First-Class Mail products by lowering prices on more profitable and price sensitive Presort letters." PB Initial Comments at 2. PB suggests this solution, but without recommending a finding of noncompliance in this docket. PB's proposed solution would apply even more to Standard Mail, where the Commission already has found noncompliance and the situation has failed to improve, if not actually worsened. By using economically rational prices, the Postal Service could easily increase total contribution even while operating within a price cap.[6]

IV. Public Representative

Pricing and underwater products. The Public Representative ("PR") appropriately lauds the Postal Service for providing shape-level elasticities for Standard Regular Flats (-0.45) and Standard Regular Parcels (-0.50) as part of its FY 2015 submission.

> The Public Representative commends the Postal Service's efforts to improve elasticity estimates, which **should assist in setting up prices** for Standard Mail products, including Flats and Parcels. [*Id.* at 34 (emphasis added).]

The PR is correct that better elasticity estimates **should**, at least in theory, assist Postal Service pricing. Of course, the Postal Service regularly ignores estimates and considerations of elasticity whenever that suits its purpose. Regrettably, the PR does not indicate how more refined elasticity estimates will overcome the Postal Service's obviously deliberate,

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[6] Indeed, although the Valpak Standard Mail Contribution Maximization Model was designed for Standard Mail, it readily could be modified to apply to First-Class Mail, so as to identify rates which increase, even maximize, the contribution obtainable under a price cap regime. *See* Valpak Initial Comments at 37.

uneconomic underpricing that has characterized Standard Flats since FY 2008. *See* PR's Initial Comments at 32, Chart IV-2.[7] No economic model supports elasticities of -0.45 justifying product prices substantially below marginal (attributable) cost. Although the PR alludes to the problem, an effective remedy is not suggested.

The PR also fails to note that an elasticity of -0.45 is a strong indication that the deeply underwater Standard Flats product could very well sustain a reasonable price increase. In fact, the PR's excellent Chart IV-2 visually demonstrates that an immediate price increase designed to raise an additional $200 million from Standard underwater products would still leave the Postal Service with an annual loss in the range of $200 to $400 million and a coverage still well below 100 percent. The PR might usefully extend its discussion of underwater products to include possible motives for continuing to pile up losses on catalogs year after year.

After briefly reciting the Postal Service's ineffective excuses for not doing more to reduce its losses on underwater products, the PR states that:

> Based on analysis of the information presented in the FY 2015 ACR, **the Public Representative cannot conclude that the Postal Service followed the Commission's directives**. Although the Postal Service gives a detailed description of the operational initiatives that took place in FY 2015, it admits its inability to provide any estimate of the resulting financial impacts. [PR Initial Comments at 33 (emphasis added).]

Service performance. The PR's Initial Comments introduce a lengthy discussion of service performance with the following:

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[7] Chart IV-2 is mislabeled as "Standard Mail," which as a whole made a positive contribution of $6.63 billion to institutional costs in FY 2015, as the PR notes at 29. The deficits shown in Chart IV-2 are for one product alone — Standard Mail Flats.

> The Postal Service is **required** to annually report the **level of service achieved** by each market dominant product (in terms of speed of delivery and **reliability**). 39 U.S.C. § 3652(a)(2)(B)(i). Whether or not the level of service achieved is in compliance with the applicable service standards is determined by comparing [1] the actual level of service against [2] service targets (goals) established by the Postal Service. Based upon this comparison, the Commission then makes an annual determination of whether or not individual market dominant products were in compliance with the service standards in effect during such year. 39 U.S.C. § 3653(b)(2). [*Id.* at 4 (emphasis added).]

Despite the PR's overview, the Postal Service has not established any service performance targets (goals) for **reliability** of delivery service for any class of mail, nor has it provided any statistical measures of the actual reliability of delivery service that might be compared to the (non-existent) targets for reliability of delivery service. In a price cap regime, such targets and statistical measures should be seen as essential to keep the Postal Service from degrading service in an effort to save money. Since the Postal Service did not establish any performance standards for reliability of delivery service in FY 2015, a Commission determination that market dominant products were in compliance with the statute's requirements vis-a-vis reliability is virtually impossible.

CONCLUSION

A recurrent theme throughout the Initial Comments of several parties in addressing a variety of products is that Postal Service pricing has been illogical and arbitrary, perhaps increasingly so. Postal pricing is sending the wrong signals to mailers and failing to encourage the growth of profitable mail, while encouraging the preservation and growth of money-losing mail. For the reasons set out above and in Valpak's Initial Comments, within Standard Mail, the Commission has a duty under PAEA to act, to act now, and to make another finding of illegal pricing and to act decisively, to increase the price of Standard Flats, and to reduce the price of other Standard Mail, beginning with HD/Saturation Letters, one of the most profitable products with the highest elasticity.

Valpak would like to end on a positive note, although this last point must not be used as another excuse for further delay. Valpak is encouraged by the combining of the Postal Service's pricing department with costing under the authority of a new Vice President for Pricing and Costing, with that Vice President now reporting to the Chief Financial Officer, who has responsibility, *inter alia*, for not losing money.[8] Therefore, when the Commission's strengthened remedial order for Standard Flats is issued, as Valpak believes it must be, there is reason to hope that it will be implemented in the spirit with which it is issued, to the financial benefit of the Postal Service.

Respectfully submitted,

/s/

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[8] Postmaster General Brennan created the new position of Vice President of Pricing and Costing, effective January 23, 2016, which reports to the Chief Financial Officer/Executive Vice President. *See* http://about.usps.com/who-we-are/leadership/officers/price-cost-vp.htm.